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DIRECTORATE OF
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Intelligence Memorandum

New Demands by the Oil Producing States: Participation

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
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INTELLIGENCE MEMORANDUM

NEW DEMANDS BY THE OIL PRODUCING STATES: PARTICIPATION

Introduction

1. Representatives of the Organization of Petroleum Exporting Countries (OPEC)(1) and the international oil companies are scheduled to meet in Geneva on 20 January 1972 to discuss the demand of OPEC members to participate, as part owners, in the management of the companies operating in their countries. The oil companies had hoped publicly that the revenue agreements concluded with OPEC members in early 1971 would provide a five-year period of stability. The demand for participation, coupled with OPEC's demand for increased revenue to offset lost purchasing power resulting from dollar devaluation, threatens that hope.

2. This memorandum reviews the current participation aims of OPEC, discusses the possible effects of participation on both parties and on world oil activities, and assesses the likely outcome of the Geneva meeting.

Discussion

Participation: Not a New Issue

3. Most of the current output of oil in the OPEC countries is produced under concession agreements that do not provide for participation by the host governments, but there are precedents that recognize this concept. A concession granted by Iran (then Persia) in 1901 provided for

1. The members of OPEC are: Abu Dhabi, Iraq, Iran, Kuwait, Saudi Arabia, Qatar, Algeria, Libya, Nigeria, Venezuela, and Indonesia.

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

participation, but this provision was dropped in a later renegotiation of the concession agreement. The agreement between the Iraq Petroleum Company (IPC) and the government of Iraq permits the latter to purchase up to 20% of any shares issued by IPC. This option was never exercised, however, because no shares have been issued.

4. In recent years, most of the new agreements – covering areas not under the old concessions – have departed from the concession arrangement. Many have followed a pattern of joint ventures in which the foreign company entered into some form of partnership or participating arrangement with a national oil company. These arrangements usually cede production rights in a defined area to a company of which the national oil company holds a portion of the shares (in most cases, 50%), the remainder being held by a foreign company, or group of companies. The foreign oil companies usually bear the capital risk during exploration and are reimbursed only if oil is found. Participating-type agreements have been achieved by Iran, Saudi Arabia, Kuwait, and Abu Dhabi. The "major"(2) oil companies have eschewed participating agreements except for Shell, a UK/Dutch firm, which has a history of being short on crude oil supplies. Smaller US companies (for example, Continental Oil, Atlantic-Richfield, Union Oil, and Phillips Oil) have been active in participating agreements as well as Ente Nazionale Idrocarburi, the Italian state oil company, and several state-backed Japanese oil firms.

5. In some cases, the agreements take the form of a service contract between a company and a national oil company, which owns any oil found as well as the facilities. Under most contract agreements, the foreign oil companies take the exploration risk and, if oil is found, advance the money required for development. The advance may be repaid in crude oil, while, in return for taking the exploration risk, the contractor is granted the right to purchase a portion of the crude oil at a low price. Contract arrangements were pioneered during the mid-1960s by the French state-owned company Entreprise des Recherches et d'Activities Petrolieres and the national oil companies of Iran and Iraq. Since then, service contract agreements have been signed in Indonesia, Libya, Algeria, Venezuela, and Nigeria. Most of the contract agreements are with smaller oil companies, but Mobil, Shell, and Gulf also have entered into this type of agreement in Venezuela and Indonesia.

6. The first collective expression by the oil producing states of their desire to modify older concession agreements was in a formal statement of goals by OPEC in 1968. Participation was made a current item of

2. Standard Oil (New Jersey), British Petroleum, Royal Dutch Shell, Standard Oil of California, Texaco, Gulf Oil, and Mobil Oil.

bargaining by a resolution passed at an OPEC ministerial conference in Beirut in September 1971.

Participation: Different Views

7. OPEC members probably are unanimous in desiring a working interest in the management and operations of the concessionaires in their countries but differ on the share of, or the method of achieving, participation. The initial demands at the Geneva meeting probably will reflect the desires of the Persian Gulf members and Nigeria. The other members – Indonesia, Venezuela, Algeria, and Libya – have different situations and are likely to be merely observers. Indonesia has effective management control over all of the concessions issued in recent years, and the agreement with its major producing concessionaire has been renegotiated to provide for government control in the future. Venezuela now exercises control over its oil industry through legislative power and executive decree, which authorize the government to set tax reference prices and tax rates and to impose production controls. Moreover, most existing concession agreements begin expiring in 1983, and full ownership is to pass to the government at that time. In early 1971, the Algerian government took over, through legislation, majority control of the foreign oil producing interests and complete control of its natural gas resources. The Algerian national oil company, SONATRACH, now produces and markets 77% of Algerian oil production. Algeria is the only major oil producing country that markets a substantial portion of its own oil production. Libya is expected to push for majority participation independent of any action of OPEC.

8. Among the Gulf States there are varying degrees of interest. Iran, for example, has little enthusiasm for the issue of participation because it expects to control its oil operations when the existing concession expires in 1979.(3) However, Iran, along with the other moderates – Saudi Arabia and Kuwait – sees participation as a way to an orderly transition of present oil activities to its control without jeopardizing the existing international oil marketing structure. These countries also agree that control over their oil resources is vital to their national goals. Nigeria has indicated it plans to seek a larger share of ownership than the Gulf States do.

OPEC's Aims for Participation

9. Although the ultimate goal of the oil producing states is complete control over the exploitation of their petroleum resources, the near-term goal is the establishment of a working interest or active participation in

3. Although companies contend that they have three five-year options available to them, Iran has indicated that these options probably will not be honored.

this exploitation. The initial demands of the Persian Gulf members probably will follow the recommendations of an OPEC working group established to study the issue. The working group does not recommend a specific percentage participation, but press reports indicate that the Persian Gulf countries will ask for 20%. The working group does recommend that the cost of acquisition for the government's share of participation be calculated on a net book value basis (depreciated capital investment) with payments in cash over a period of years, as yet unspecified. This formula would result in a relatively low valuation and would impose no serious hardship on the governments. The working group also proposes, however, that the governments finance their share of future operating and development costs.

10. The OPEC members are anxious to avoid disrupting world oil prices and will propose that the oil companies market any oil their national oil companies cannot. The price at which "participation oil" marketed by the companies would be credited to the countries' account is expected to be a contentious issue. OPEC probably will propose a formula by which the price credited would provide the countries a profit per barrel approximately equal to the profit that the companies now realize.

11. Although some moderate revenue increases would accrue to the producing states through participation, their primary goal is to achieve a greater say in the production and investment decisions made by the companies and a better position from which to monitor the oil companies' operations. The national oil companies of the producing states would gain managerial experience and expand their technical competence.

Companies' Position

12. The oil companies through the London Advisory Group, composed of representatives of 22 international oil companies, have solidified their position. The companies have no intention of negotiating this complex issue at the Geneva meeting; they probably will listen to OPEC's demands and promise to give them careful consideration. It seems likely that the Geneva meeting will be only the beginning of a series of long, arduous negotiations taking place over many months.

13. The companies' legal position is that the participation demands are a violation of the revenue agreements of early 1971, which promised financial stability through 1975. At future negotiations the companies almost certainly will oppose the net book value concept of assessing the cost of acquisition as being too low and not taking into account future earning capacity (discounted cash flow). The companies also will try to recoup some of their lost revenue by pushing for a lower price for the participation oil they are obligated to market for the governments.

Strengths and Weaknesses of Both Sides

14. The agreements for greater revenues imposed by OPEC in early 1971 clearly demonstrated the shift in the balance of bargaining strength from the companies to the OPEC member states, who account for 60% of the world's proved oil reserves and about 90% of the world's oil exports. No alternative sources of oil or energy are likely to become available in the near term at reasonable cost. Even with the new oil discoveries in the North Sea and Alaska, the oil importing countries will be heavily dependent on oil from the OPEC members at least through this decade. Moreover, the OPEC countries represent the sources of the lowest-cost oil and the highest potential profits.

15. The OPEC solidarity that characterized the revenue negotiations, however, may not be maintained at the Geneva meeting, because of differences in interests and motivation. Moreover, the Arab states, particularly Iraq, are antagonistic toward Iran – the leading force in the 1971 negotiations – because of the "Gulf Settlement".[4]

16. In some respects there is a mutuality of interests between the companies and the producing countries. Control of oil resources is worthless unless oil can be transported, refined, and marketed, which the oil companies alone are equipped to do. Only the companies have the technical ability and vast capital resources necessary for continued rapid growth of world oil production. Moreover, the oil producers recognize that the companies, working in concert, provide stability to the oil market and hold up oil prices by informally rationing output. They are aware that mutual cooperation on production policy – without the companies – would be very difficult because of differences in the cost of oil and in the urgency of need for increasing oil income. The OPEC countries have been able to achieve a common position on price policy, but this accomplishment was greatly facilitated by the companies' control over marketing.

Prospects for the Geneva Meeting and After

17. The Geneva meeting is unlikely to lead to a showdown between the oil companies and the oil producing countries. It probably will serve only for preliminary talks, which will be followed by long, arduous negotiations on a country-by-country basis. Both sides probably will seek a cooperative agreement; neither side wants either the flow of oil or the

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4. On 30 November, Iranian forces occupied Abu Musa island and the two Tumbs islands in the Persian Gulf as part of a settlement with the Ruler of Sharjah. Most of the Arab countries issued statements deploring Iran's action. The most severe reaction came from Iraq, which broke off diplomatic relations with Iran.

marketing system to be disrupted. The oil companies will argue and resist but ultimately will be forced to accept some degree of participation and to settle for payment based on net book value of their assets.

18. Participation is not expected to result in a major restructuring of the world oil market. The governments have long been influencing the production decisions of the companies. The Shah of Iran, for instance, annually prods the Iranian consortium to raise production. Participation will undoubtedly enhance the governments' ability to influence production and investment decisions, but the governments will be able to exert influence only on the companies' indigenous operations, which are primarily extractive in nature. The parent multinational company will continue to make the major decisions, including those on refining and marketing. The oil producing countries will undoubtedly increase their revenues but at the same time will be forced to share in operating costs and the costs of new investment. Company earnings may decline but the impact on net cash receipts (earnings less new investment) may be small. Moreover, participation may provide the companies a degree of political insurance against arbitrary advice by governments. The potential for discriminatory treatment against US companies, for instance, may be lessened by participation.

Conclusions

19. At the Geneva meeting, OPEC's participation demands will be muted by the mutual interests that exist between the oil producing countries and the oil companies. The OPEC members recognize their dependence on the companies' technical ability, capital resources, and orderly control of the world oil market. The oil companies, on the other hand, depend on OPEC for most of their oil supplies. In the face of these realities, it is unlikely that OPEC will be so demanding or the oil companies so adamant that a disruption in oil production or marketing will result from the participation issue.